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16 MAR 1962Shift in Allocation of Soviet Resources to Military Uses?Summary and Conclusions

Over the past three months, Embassy Moscow has commented frequently on the relatively poor performance of the Soviet economy since 1961, in comparison with previous years. More recently, the Embassy has estimated that these reduced rates of increase in economic activity probably have been caused by a significant diversion of resources to military uses.* It suggests an increase of \$4.5 billion in Soviet defense expenditures for the latter half of 1961 and the year 1962.

The Office of Research and Reports (ORR) has reexamined all available evidence of possible resource shifts and plan shortfalls within the Soviet economy. We agree with the conclusion that their economy is showing signs of a moderate slowdown in the previous high rate of growth. However, in our opinion, the lessened tempo of expansion cannot be attributed to a military speedup. Our reexamination of current Soviet military programs will support only a modest increase in military outlays in 1961 and a much more substantial but still absorbable boost -- on the order of \$1.2 billion -- in 1962.

The evidences of economic strain which have developed in recent months are difficult to evaluate. However, in the discussion which follows, we have summarized our views on each of the 18 indicators put forward by the Embassy to support the likelihood of a substantial shift of resources to defense purposes. Despite the risk of being too succinct in our comments and appearing overly confident in our measurement of a variety of small changes in military expenditure between the two years, the following conclusions have been drawn:

- (1) It is believed that an increase on the order of \$1.2 billion in Soviet military expenditures between 1961 and 1962 -- a downward revision of our present estimates** -- seems consistent with the evidence to date. Moreover, we believe

Note: This memorandum represents the views of the Office of Research and Reports, Central Intelligence Agency, as of 15 March 1962.

* Airgram A-668, dated 23 February 1962.

** "Present estimates" refer to the calculations included in the memorandum to holders of Annexes A and B, NIE 11-4-61, dated 10 January 1962.

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there is ~~now~~ additional evidence to support the previously expressed view that a large portion of the Soviet announced change in the explicit budgets -- an increase of \$4.5 billion -- was a book-keeping transfer from previously "hidden" accounts.

(2) There is no firm indication that the Soviets have recently shifted a significant portion of the capacity of the machine building industry to the production of military equipment;

(3) It is not believed that the construction component of military expenditures is large enough to cause a significant impact on the other areas of the economy, even if sizable increases related to construction for military purposes had occurred;

(4) The slowdown in the rate of increase in per capita consumption of food, housing, and clothing in 1961, is basically related to the failure of the agricultural sector to maintain growth rates during the Seven Year Plan of the order experienced between the death of Stalin and 1958, and to the ideological penchant of the Government to restrict private housing construction.

In summary, while recognizing that: (1) the Soviet Union has probably now budgeted more funds for defense than it originally had planned for 1962, and (2) that changes in levels of expenditures for defense programs could cause temporary dislocations in certain segments for the economy, we cannot at the same time support the Embassy's proposition of the magnitude of the military increase, or that it has been the principal cause of the recent difficulties experienced by the Soviet economy.

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Discussion

Shift in Allocation of Soviet Resources to Military Uses?

Over the past three months Embassy Moscow has commented frequently on the poor performance of the Soviet economy in 1961 relative to previous years, and the prospects of further deterioration in 1962. In recent weeks the Embassy has further suggested that these indications of reduced rates of increase in economic activity are primarily related to the diversion of resources to military uses.

More specifically, two themes are prominent in Embassy reports:

(1) The economy is currently under increased strain due to an overcommitment of resources and a slowdown in rates of growth in 1961;

(2) One of the important causes of this setback in 1961 is the shift in resources from the civilian economy to the military sector.

ORR concurs with the notion that the economy is currently showing signs of a moderate slowdown in the usual high rates of increase in output. However, we would differ with the Embassy evaluations in three important respects:

(1) The 1961 industrial performance, as distinct from that of agriculture, was relatively satisfactory as measured by Soviet standards of growth, and quite high when measured by Western yardsticks.

(2) Our views on 1961 performance are necessarily somewhat preliminary because the relevant data for a meaningful analysis of events remain incomplete. For example, the level of total investment activity is unknown. If a normal pattern of publication of official data prevails this and other "missing pieces" will be available shortly;*

(3) We believe the Embassy has misinterpreted some of the statistics released to date. Examples of this

* The "short" statistical abstract for the previous year has been published at the end of March for the past two years, the larger edition in the fall.

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misinterpretation will be discussed below in connection with the comment on the diversion of resources to military use. In arriving at this conclusion, we do not wrap ourselves in the cloak of omnipotence, but realize that the data available to Washington analysts compared to those in Moscow are more complete.

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ORR does not concur in the Embassy's belief that there probably has been a large diversion of resources to the military sector. The Embassy suggest an increase of 4.5 billion dollars in defense expenditures for the latter half of 1961 and again in the year 1962. We feel that the ORR estimate of an increase of about one billion dollars is more consistent with the evidence. The Embassy's views and supporting evidence are set forth in a recent Airgram (No. 668, dated 23 February 1962). Because of the implications for US policy it is important to consider in some detail the evidence of a possible shift in resources.

The above referenced Airgram lists 18 indicators of a shift in the allocations of resources to defense. In supporting our belief that there probably has not been nearly as large a diversion of resources as suggested by the Embassy we will comment on each of the indicators. This exercise will also provide background for our general agreement with the Embassy that the economy is currently under strain.

Taking the items underscored in the Embassy's Airgram in order:

Indicator A:

Unexpected appearances of defense goals in major economic pronouncements, such as Khrushchev's October 17 speech, the 1962 Plan and the 1962 Budget; the change in emphasis during 1961 may be exemplified by Party directives quoted in defense expenditure sections of the 1961 and 1962 budget messages, i.e., "to maintain the nation's defense capacity at a proper level" (1961), "to increase in every possible way the defense capacity of our country" (1962);

Comment: We have found from experience that such official statements are often ambiguous and are not reliable indicators of a shift of emphasis within the economy.

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Indicator B:

Notable failure of the Soviet economy in 1961 to come close to planned capital investment growth in key sectors; sizable reductions in growth of capital investment scheduled for 1962;

Comment: This is the indicator most suggestive that competitive uses--perhaps military--for investment goods have significantly reduced the availability of resources to the latter. The available data appear in Table 1. It is difficult to generalize about the performance of total investment in 1961 because the data for the agricultural sector remain incomplete. The latter series when included could significantly modify the direction of trend of equipment investments. In 1960 the agricultural sector invested nearly 20 percent of all equipment used for investments. In any case, from the limited data we have available the most important underfulfillment will be in the construction component; equipment investments only slightly below the rate of increase for the previous year.

Table 1

Changes in Investment, 1959-62
(Annual Percentage Change)

	<u>1959</u> <u>Actual</u>	<u>1960</u> <u>Actual</u>	<u>1961</u> <u>Plan</u>	<u>Actual</u>	<u>1962</u> <u>Plan</u>
Total investment (excluding agriculture)	14	9	N.A.	3	N.A.
Of which:					
Equipment	16	10	N.A.	8	N.A.
Construction	14	9	N.A.	0	N.A.
Investment in selected industries					
Ferrous metallurgy	25	12	31	8	11
Oil and gas	14	11	16	8	6
Machine building	19	18	40	14	14
Chemicals	53	35	42	13	18
Construction materials & construction industry	20	15	N.A.	1	N.A.
Food and light industry	16	16	54	18	34

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With respect to the construction component, an important alternative explanation to diversion is that the rate of increase in the output of building materials has dropped significantly over the past three years as follows:

	<u>Annual Percentage Increase</u>
1958 1959	15
1959 1960	10
1960 1961	6+ (Est.)

Thus the relative lack of materials plus inadequate planning and management of investments (reflected in official complaints) may be the relevant factor in shortfalls rather than diversion of resources to military uses. Also, account should be taken of the very ambitious rates of increase planned in some industries -- 42 percent in chemicals and 40 percent in machine building, for example. With such targets, short-falls in achievement are not unexpected as a normal consequence of over ambition.

Indicator C:

Notable success in machine building (including armaments) industry despite underfulfillment in key sectors, suggesting offsetting increases in military production;

Comment: The above is a precis of a more detailed analysis forwarded by the Embassy (Airgram No. 596, 26 Jan 1962). In that report the Embassy cited two types of evidence to support the notion of a possible significant diversion of resources to military uses:

- (a) The underfulfillment of the 1961 targets for the output of certain commodities included in machine building and metal working (MBMW);
- (b) The large difference between the percentage increase in the gross value of output for MBMW as a whole and the increases for individual categories so far announced whether output was below or above the goals.

With regard to the underfulfillment of certain categories, the Embassy cited seven items in the machine building industry as having underfulfilled their production plan for 1961. These seven categories accounted for less than 15 percent of the total gross value of output

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for machine building in 1959.

The Embassy is on firmer ground when it takes note of the high rate of growth for machine building and metal working (MBMW) as a branch of industry -- 16 percent -- compared to the lower rates of increase for the individual categories under MBMW. However, there is a consistent differential over time -- varying in size -- between the official gross output for MBMW and ORR indexes of machinery computed by aggregating output of the various types of machinery within MBMW. Comparing ORR's civilian machinery index to the overall official indicator for MBMW clearly shows this discrepancy:

	<u>Annual Percent Increase</u>			
	<u>1958</u>	<u>1959</u>	<u>1960</u>	<u>1961</u>
Gross value of output for MBMW (official)	14	15	16	16
ORR's civilian machinery index	10	13	7	11

However, ORR's index is believed to be biased downward for the following reasons:

- a. New types of equipment are not included in the sample;
- b. Changes in quality (including complexity changes) of models within those categories of equipment included in the sample are not adequately reflected in the valuation process;
- c. Coverage of spare parts (a rapidly growing category of producer's equipment) is limited in the sample.

In any case the direction in change in the differential between the two series (shown above) suggest that the military equipment component of MBMW has not significantly changed during 1961.

Indicator D:

Failure to meet 1961 plan goals in certain major industries, including pig iron, steel, rolled metal, steel tubing; "serious deficiencies" in industry noted;

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Comment: The latter reference to "serious deficiencies" in industry supports the "economic slowdown" proposition put forward by the Embassy but would not necessarily support the hypothesis that military spending has caused a significant shift in resource allocation.

With reference to the output of ferrous metallurgy the following should be noted:

a. Output in 1961 of three of the four items listed -- pig iron, steel and rolled metal -- were less than 1 percent below the annual plan -- which had been significantly adjusted upward; steel production was up a respectable 6 million net tons:

b. Output of these three items was significantly above that originally proposed for 1961 in the seven year plan -- 2, 6, and 7 percent above, respectively.

Indicator E:

Failure in 1961 to maintain "no less than the 9-10 percent annual increase in industrial growth," announced by Khrushchev as late as October 1961 for the next twenty years; cutback in 1962 industrial goal to 8.1 percent.

Comment: Twenty year plan goals are irrelevant for the purpose at hand -- detecting current shifts in resource use.

With respect to the 1962 goal we have two comments:

a. Since the beginning of the seven year plan the annual plans have been consistently below the actual achievements. Industrial output had the following trend:

	<u>Plan</u> (Percent increase-official)	<u>Actual</u>
1959	7.7	11.0
1960	8.1	10.0
1961	8.8	9.2
1962	8.1	

b. In order to fulfill the Seven Year Plan goal an average rate of increase of only 7.8 percent is required.

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Indicator F:

Failure to meet retail and foreign trade plan goals in 1961; notable slowdown in commercial negotiations over the past three months; reported shortage of liquid assets.

Comment:

Retail Trade: Retail trade in 1961 increased 4 percent compared to a plan of 5.8 percent, primarily reflecting a disappointing year in agriculture, particularly livestock. In January 1962 retail trade was picked up and is currently running 7 percent above last year.

Foreign Trade: Turnover increased 4 percent compared to a plan of 6.5 percent. It is believed that the exacerbation of Sino-Soviet relations (unplanned) is responsible for most of the underfulfillment.

Indicator G:

Apparent reversal of trend towards consumers' goods enunciated by Khrushchev early in 1961; failure to meet consumers' goods production plan in 1961.

Comment:

Policy: The primary reasons for the short-fall in consumers goods were (1) the failure of agriculture to reach planned output goals, and (2) the ideological decision by Khrushchev to cut sharply the construction of private dwellings. From the data at hand the annual plan goals for consumer goods were met except for certain consumer durables -- refrigerators, washing machines, sewing machines. Although there were significant underfulfillments (5 to 25 percent) below the revised (upward) plan for these three items, increases in output were impressive -- 30, 36, and 7 percent, respectively.

Indicator H:

Notable failure to meet labor productivity plans, which could be connected to uneconomic (military) utilization of resources.

Comment: It is unlikely that the failure to meet labor productivity goals is evidence of a shift to military production. Other factors appear to explain this phenomenon. First, labor productivity goals

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traditionally have been underfulfilled in industry and construction. Second, some underfulfillment of productivity goals (output per person working) was to be expected as the shorter work week was adopted in the low priority industries where reserves of labor probably did not exist.

Indicator I:

Partial moratorium of new capital construction because of "dispersal of resources."

Comment: This has an ambiguous interpretation. Although it could suggest diversion of construction materials to the military sector it could also mean nothing more than what Khrushchev indicated it was -- an attempt to reduce the rapidly increasing volume of unfinished construction.

Indicator J:

Notable failure in housing construction.

Comment: Housing construction fell eight percent in 1961 and is considerably below the Seven Year Plan. It is believed that the most important cause was the drop in output of building materials (see B above), and the curtailed construction of private housing.

Indicator K:

Unusual reduction in "national economy" category of budget for 1962 (1.5 billion rubles) and extraordinary increase in the overt defense budget (4.1 billion rubles).

Comment: The reduction in the budget expenditure item of "financing the national economy" of 1.5 billion rubles is believed to be explained by a "surfacing" of hidden defense expenditures. In other words, part of the increase of 4.1 billion rubles in the explicit defense budget is offset -- not supplemented -- by the decrease in this item compared to the 1961 budget. Besides 1.5 billion rubles believed to be diverted to the explicit defense budget from the "hidden" category -- under "financing the national economy" -- another 1.4 billion rubles in defense funds was believed to have been "surfaced" from the overall Budgetary Expenditure Residual. This latter residual was known to have been more than 2.5 billion rubles in the previous year. (See the appended note on Soviet Military Expenditures, 1962 versus 1961).

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Indicator L:

The 45 percent increase (over the 1961 plan) in the numerical strength of the armed forces, as reported by Washington.

Comment: Our current estimate of the change in the level of the armed forces is an increase in the numbers from 2.7 to 3.1-3.2 million or an increase of 15 to 20 percent.

Indicator M:

The extraordinary nuclear test program in late 1961, which may have been followed by increased investments in bomb production facilities and which might not have been included in the 1961 budget.

Comment: The recent tests could well be followed by further investment in weapons production facilities. However, it is doubtful that such investment would exceed 50 million rubles.

Indicator N:

Unprecedented Warsaw Pact maneuvers which might not have been foreseen in the 1961 budget; internal military movements connected with the Berlin situation.

Comment: We are inclined to feel that the Warsaw Pact maneuvers and other internal movements last year even if unanticipated would be relatively insignificant in terms of effect on expenditures.

Indicator O:

The overall financial problem of East Germany and East Berlin as increased drain on the Soviet treasury, unanticipated in the 1961 budget.

Comment: It is not clear how this provides evidence on the diversion of resources to military purposes.

Indicator P:

Increased production of traditional weapons suggested by the notable success of the machine building industry.

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Comment: A discussion of the problem of using the overall official index for machine building was discussed under C above. Incidentally, more than the production of "traditional weapons" are included in the official output of machine building -- e.g., missiles are also included.

Indicator Q:

Possibly increased Soviet efforts in research and development, science, space, missiles, nuclear-powered submarines, new weapons.

Comment: With one exception (anti-missile-missile systems) there is no evidence of any sharp change in the rate of activity.

Indicator R:

Increased wage bill resulting from the "voluntary" return to the 8-hour day rumored in defense plants.

Comment: Aside from the original public offer (8 August 1961) by "workers" for a "voluntary" return to the 8-hour day in defense plants and Khrushchev's statement on 11 August we have no information indicating a return to a longer workweek in these industries. Khrushchev's answer to the original offer "permit us to avail ourselves of it depending on the situation. Leave it to your government and the Central Committee of the Party." To date, we have been interpreting the original interplay as staged sabre-rattling.

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Appendix

Soviet Military Expenditures, 1962 Versus 1961

Table 2 compares the changes in 1961-1962 in Soviet military expenditures as previously estimated and attempts to appraise in general terms what these relationships probably would be if revisions were made today and some of the major uncertainties were taken into account.

Whereas the National Estimate indicated a 2 billion (new) ruble increase in 1962 as compared with 1961, it now seems more likely that the increase will be about 1 billion rubles. If reasonable weight is given to some of our major uncertainties about relative changes in ruble expenditures (such as land armaments, and research and development) it seems unlikely that more than an additional increase of 1 billion rubles (1 1/2 billion at the outside) could occur. For this reason, among others, we are inclined to feel that a large portion of the increase in military expenditures for 1961 as announced in the explicit defense budget was a matter of bookkeeping transfers. That is, military expenditures previously financed outside the explicit allocation and "hidden" in other budget categories have now been "surfaced" and included in the explicit defense budget for propaganda and perhaps for regularizing (at least to a considerable degree) Soviet budgetary accounting practices, possibly in preparation for disarmament talks.

For these same reasons we are also inclined to regard the 1 billion ruble increase in the explicit defense budget announced for 1962 as at least generally indicative of the real change between 1961 and 1962.

The rationale for the revisions indicated in the Table are as follows:

1. In the area of expenditures related to personnel -- including operation and maintenance and the procurement of organizational equipment -- the previously estimated increase was reduced by half because we now believe some demobilization will occur in 1962. Therefore, the force levels in terms of manpower will not be as great as was carried in the original estimate.

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Table 2

Increases in Soviet Military Expenditures from 1961 to 1962
Based on Present Estimates and on Possible Revisions
(million rubles a/)

	<u>Present Estimates b/</u>	<u>Possible Revisions c/</u>
TOTAL Net Increase of which;	1,800	1,100 to 1,900
Personnel	740	370
Facilities	50	50
Procurement of Equipment of which;		
Land Armaments	-50	-50 to 500
Naval Vessels	0	0
Aircraft	440	30
Ground Electronics	50	80
Guided Missiles	170	170
Nuclear Weapons	210	210
Research and Development	200	200 to 500

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- a. Data in this table represent estimates originally prepared in terms of 1955 (old) rubles and converted to new rubles at the rate of ten old rubles for one new ruble.
- b. Data in this column were obtained by subtracting the 1961 estimate from the 1962 estimate for each category, using the material which was prepared in support of the National Estimate last year.
- c. See accompanying text for explanation of the revisions.

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2. Estimates of the procurement of land armaments may be regarded as subject to a considerable uncertainty. It is conceivable that the estimate for 1961 is too high, especially if one considers that demobilization was the order of the day in 1960 and, probably, initially with respect to 1961. For these reasons it may be considered as within the realm of possibility that 1962 will show an actual increase of 500 million rubles as compared with 1961 and this possibility is reflected as an upper limit for the category in Table 2.

3. The aircraft estimates for 1962 were revised downward because the estimated advent of the nuclear propelled bomber seems unlikely in 1962. In addition, the Blinder program is building up slowly and the aggregate of the fighter aircraft programs will show little increase.

4. The slight adjustment in the estimate for ground electronic equipment is the result of a review and revision of previous estimates.

5. The estimate for Soviet research and development is another of our estimates that is surrounded with considerable uncertainty. Moreover, this estimate is admittedly conservative and is certainly insensitive to year to year changes such as are in issue here. Therefore, it is felt that a possible increase of 500 million rubles is a likely magnitude. (Because of the uncertainty, however, it must be conceded that an increase of 1 billion rubles -- not shown in Table 2 -- is a realistic upper limit).

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